

Talking Heads podcast with Geoff Dailey

Daniel Morris: Hello and welcome to the BNP Paribas Asset Management Talking Heads podcast. Every week, Talking Heads will bring you in-depth insights and analysis on the topics that really matter to investors. In this episode, we'll be discussing US small cap stocks. I'm Daniel Morris, Chief Market Strategist, and I'm joined this week by Geoff Dailey, Head of US Equities. Welcome Geoff, and thanks for joining me.

Geoff Dailey: Thanks for having me, Daniel. Happy to be here.

DM: Despite all the craziness we've had to go through over the last several months, I would imagine from where you're sitting, looking at US small cap stocks, it's not necessarily been quite so bad if we look at the returns.

For the Russell 2000, from the low last month, the Russell 2000 is up 15%. Compare that with 13% for the large cap indices in the US, 9% for [the] Russell Value [index]. So that's a nice performance. In addition, if we look at how the earnings season is going, reported earnings so far show 10% year-on-year growth.

And if we look at [the] forecast for the whole year, it's 70%. Though that reflects not quite so strong earnings in 2025. So, a bit of a base effect there, but still positive numbers, a good trajectory. The recent macro data we've had in the US has also been encouraging, and of course we are looking for some reductions in interest rates from the Fed at some point this year.

For you, Geoff, could you talk about how you've seen the beginning of 2026 and how US small caps have evolved? Certainly, we want to talk about the impact of the conflict in the Middle East, and any other themes you see as critical for the quarter.

GD: As you aptly described, small caps have started 2026 on a strong note, with the Russell 2000 up just over 10% year to date through April 24th, outperforming the S&P 500 large cap index, which is up only 4.5% year to date. ~~SoSo~~, a really nice outperformance by small caps to start the year. That said, it hasn't been a straight line higher.

The conflict in the Middle East created decisive shifts in market sentiment and leadership throughout the period. We think about the period in three phases. Phase one was from January into late February. Equity markets were reacting to signs of improving growth and sentiment. The consumer [market] appeared healthy.

AI (Artificial Intelligence) capex was strong, and leading manufacturing indicators like ISM moved into expansion. The market began pricing in steady growth and easing inflation. This led to a broadening of the market with investors rotating beyond just the biggest tech stocks. With that backdrop, small caps did well. The Russell 2000 was up 8% by late February from the beginning of the year – a solid start.

But then phase two – a de-risking phase that ran from the outbreak of the conflict in late February through March. This period was marked by significant uncertainty about the depth and length of the war, specifically disruption of key shipping lanes, energy prices, and other raw materials dependent on the Strait of Hormuz spiked higher.

Thus, inflation expectations grew higher as well. Consumer confidence shrank and investors feared compression of corporate margins. An unfortunate stagflation scenario. Expectations for rate cuts for the remainder of the year also diminished during this period. So unsurprisingly, small caps sold off sharply in this period with the Russell 2000 down roughly 10%.

Phase three was what we've seen since late March. Markets stabilised and then rebounded as signs of de-escalation emerged. Oil prices retreated from the peak and worst-case inflation fears subsided.

Investors have refocused to company fundamentals and earnings. This has been more akin to the start of the year, with small caps up 15%. Clearly policy and inflation implications are still fluid at this stage, but the market is beginning to price in lower geopolitical risk.

In terms of the themes that drove the quarter, AI once again dominated having both positive and negative impacts on industry groups. There was a clear intensification of the AI infrastructure boom that helped semiconductors, tech, hardware engineering, construction firms and power stocks.

Conversely, the rapid advances in product development in agentic AI pressured software stocks that were felt to be at risk of disintermediation. This led to a third theme – concerns that private credit, liquidity and markdown risk would weigh on the broader financial system. This led to weakness in alternative asset stocks and banks. So clearly a number of crosscurrents and volatility, but generally it demonstrated the resilience of US equity markets and US small caps.

DM: You mentioned AI as a critical theme and to some degree coming back to be a focus for the market now that the war has faded slightly. Maybe you can pick up and develop [on] that divergence you saw between the infrastructure stocks that were benefiting and the software stocks that initially suffered. How do you see the outlook for the two groups?

GD: The performance gap between AI infrastructure, stocks and software has been striking this year. For example, the iShare semiconductor ETF [exchange-traded fund] is up over 50% while the iShare software ETF is down nearly 20%. Driving the strength in AI infrastructure stocks is the continued increase in hyperscaler capital spending expectations.

The Big Five US hyperscalers are poised to increase capex by over 70% year over year in 2026, and we anticipate AI capex will grow robustly again next year. Not only are capex numbers moving higher, but product development and revenues are coming on faster than expected. All of that is giving investors more confidence that the spending wave will be both large and long-lasting.

Strong visible capex is a supportive tailwind for these AI infrastructure stocks. After the strong move, one has to be cognizant of evaluations, but the sustainability of spend in the early stage of revenue acceleration for many will lead to positive earnings revisions for our semiconductor and AI hardware stocks.

While we are discerning about the healthy moves in the group, we're still finding attractive ideas with best-in-class business models and revenue outlooks. On the other hand, stocks with

business models perceived as at risk from rapid advances in agentic AI have been under significant pressure this year.

Earlier this year Anthropic unveiled [its] Claude Cowork workflow tools and domain-specific products that demonstrated far-reaching capabilities. This caused a downdraft in software stocks whose business models were thought to be at risk from the innovation. While we do not want to underestimate the pace of disruption, we believe there are characteristics that can lead to business resilience within the software space, and valuations are at trough levels.

We favour incumbents with proprietary data systems, strong governance or trust moats in sizable installed bases in sales forces. We see the AI infrastructure bucket as having more valuation risk.

While the AI disintermediation group has more business model risk, we're finding attractive ideas in both spaces, but you have to be discerning finding those names with strong competitive advantages, resilient business models and innovative cultures.

DM: Let's pick up on the other risks that you talked about related to AI. It wasn't just concerns about the business models for the software stocks, but also about the financing for those companies and the spillover that we saw into the banking system and concerns about private markets. Do you see those risks as well founded and in particular, what are the risks for small cap stocks?

GD: There are two primary concerns related to private credit at the moment – liquidity risk and valuation risk. We do not think either will rise to the level of systemic risk or have a negative fundamental impact on our small cap banks. We do think it's reasonable to assume that a number of private market portfolios will have to reduce the value of holdings in the software sector.

While this will negatively impact fund performance for those select private credit funds, we do not view this as a risk to the system. On the liquidity side, we're seeing elevated redemptions from select retail-oriented private credit vehicles. These vehicles are structured with rules to protect against so-called runs on the bank.

However, we view those liquidity demands as manageable, and neither the write-downs nor the redemptions look like they will rise to [be] a systemic risk to the broader financial system. As to small cap banks, they're generally not heavily involved in lending to private credit or private equity directly. Small cap banks have low single-digit to zero exposure to non-depository financial lending. In addition, small cap banks are generally under allocated to software lending.

So, while small cap banks are exposed to an industry-wide credit cycle, we believe they're largely insulated from [any] deterioration in private credit markets as it relates to access to capital for our small cap companies. That was a pullback by private credit companies. It's our view that there is still ample capital available. Reputable private credit funds continue to demonstrate the ability to raise capital and given more lenient capital rules.

banks will also play a greater role in providing credit to smaller businesses, so we do not think access to capital will be disrupted as a result of any potential pullback in private credit.

DM: Let's look at the broader picture and the outlook. How do you see that for small caps right now and in particular, where do you see the opportunities?

GD: Despite the strong headline moves of the Russell 2000, our sector experts are still finding a number of stocks with material upside and favourable risk/rewards.

We see an opportunity for the favourable backdrop that was emerging late last year and into this year to continue. Clearly, we need to see a de-escalation in the conflict in Iran, but as we do, there are a number of tailwinds for small caps that could reemerge. These include open capital markets, healthy M&A (mergers & acquisitions) pipelines, improving industrial activity, strong domestic capex, and a resilient consumer.

While the labour market is softening from benign levels and the lower-end consumer is clearly under pressure, the vast majority of consumers are employed, spending and have a solid savings position. Despite the uncertainties caused by the conflict in Iran, there is generally still a constructive backdrop to the earning season.

On top of that, we have a market that's now less dovish than it was. A flip by the Fed could easily add more rate cuts to the picture, providing another tailwind to small caps. As for specific opportunities, we take a balanced approach given the macro risks, but on the more economically sensitive side, we're seeing attractive opportunities in small to mid-cap banks and early cycle industrials.

Industry leaders and strong competitive positions within these industries will allow these companies to weather down cycles and participate strongly in a healthy economy and a broadening market. And valuations are reasonable here as well. We also see an opportunity in a number of the software stocks that have been pressured by the threat of agentic AI.

We believe that the advent of agentic AI changes how software will work, but some of the existing software companies are in a great position to capitalise on these developments. Agentic AI increases what software is capable of and thus should expand the addressable market. Some will undoubtedly be disrupted, but many will benefit, not just prove resilient.

As we noted earlier, many have built-in advantages including proprietary data, systems of record position, strong governance or trust moats and sizable installed bases in sales forces. Cybersecurity is one of those areas that's been negatively impacted by sentiment, but an area where we see huge opportunity.

Cyber threats will only grow with increased AI prevalence, and the incumbents are best positioned to thwart these attacks. These cybersecurity incumbents are highly integrated into operations of a company. They have built tremendous trust, have demonstrable experience and expertise. The total addressable market is growing and many of these providers will be hard to unseat.

We also continue to find attractive opportunities in small and mid-cap cap growth, healthcare, small cap med tech stocks that performed very poorly to start the year, despite no change in fundamentals. While difficult to predict [the] timing, we ultimately believe this will reverse.

Given these strong fundamentals, we also expect this to be an area ripe with high premia takeouts. So overall, while we're cognizant of the uncertainty of the geopolitical risks weighing on the markets, we're finding attractive opportunities and are cautiously optimistic that small cap tailwinds can reemerge as tensions in the Middle East ease.

DM: Geoff, if I could summarize some of the key takeaways you shared with us, probably number one is that [the] fundamentally positive macro-outlook that we had at the beginning of the year really is still there despite the turbulence we saw in March with the outbreak of the war.

You still see supportive economic activity in the US – rate cuts and mergers and acquisitions should be supportive, industrial activity and so on. And importantly, you highlighted solid consumer demand for particular themes.

You pointed out both the risks and the rewards related to AI – certainly a positive impulse on the infrastructure side and risks on the software side, but at the same time because of the broad sell-off you'd seen in that space, there are always opportunities to be found.

Geoff, thank you very much for joining me.

GD: Thank you, Daniel, happy to be here.

DM: That's it for this week's episode of Talking Heads. If you would like more information about our capabilities in US small caps, please reach out to your asset management contact or check out Viewpoint, our website for investment insights at [Viewpoint.BNPParibasam.com](https://www.viewpoint.bnpparibas.com).

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Please do join me next week. Until then, take care.